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ABSTRACT

Issues concerning new tuition savings plans are considered, along with illustrations from four plans. A prepayment model plan and an update on federal legislation affecting savings plans are also presented. Financial issues for families, tax issues, and financial issues for colleges are covered. The idea behind parental savings plans is to allow parents to "purchase" higher education at today's prices for use in the future while achieving some tax benefits. The more restrictive the policies for use and the greater the withdrawal penalties, the less financial risk there is to the plan. Key features of savings plans at Calvin College and Duquesne University and state savings plans in Michigan and New Jersey are considered. In addition to a brief overview of the plans, information is provided on purchase amounts, eligibility, price, corporate structure, withdrawal features, investment risk, transferability, and operational status. Also examined is a model plan developed by the National Forum for College Financing Alternatives. The effects that proposed tax reforms at the federal level would have on the attractiveness of college savings proposals are also addressed. (SW)

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CAPITAL IDEAS

a newsletter of the
NATIONAL FORUM FOR
COLLEGE FINANCING ALTERNATIVES

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New Tuition Savings Plans

Stretching Tuition Bills into the Pre-College Years

U.S. DEPARTMENT OF EDUCATION
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The purchasing power of federal student aid expenditures declined over 25 percent during the 1980's. Moreover, the current pressures on the federal budget portend a continuation of this trend. One effective way for states and colleges to lessen the impact of these cuts on enrollments is to encourage families to save for higher education prior to enrollment. Indeed, enrollment management has been a major factor behind the appearance of "college savings plans." These programs can, however, be complicated and may have significant tax implications. It is important that those interested in developing or participating in these plans understand the range of issues they may face. This edition of the Forum's **Capital Ideas** will review some of these issues as well as the benefits and risks of different approaches. Illustrations are taken from four sources. Calvin College and Duquesne University have plans in place that serve as models for institutional plans. The Forum has worked closely with the governor's staff in the State of Michigan in developing a statewide plan. We are now working with the State of New Jersey which has put forward an "early draft" plan for discussion purposes. Highlights of both of these state plans are discussed. In addition, the Forum has developed a prepayment "model" of its own that is also analyzed.

The Concept. Parents generally save for higher education as they save for any other large purchase. Unfortunately, as they put money aside for higher education, they face two problems. First, the income generated by the savings, e.g., interest and dividends, is taxed. Consequently, tax-sheltered savings in retirement accounts, housing, and life insurance provide more attractive investment vehicles. Saving in a child's name, either through the use of a trust or a transfer under the Uniform Gift to Minor's Act can also create tax advantages, but these forms of savings may be cumbersome and their tax advantages are threatened by tax reform proposals. Parents face a second problem regardless of the fate of tax reform: finding investment vehicles which are guaranteed to match the rate of increase in the costs of attending higher education. The idea behind "parental savings plans" is to allow parents to "purchase" higher education at today's prices for use in the future while achieving some tax benefits.

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Issues for Families. Families will participate in college savings plans if they perceive them to have high utility with limited risk or to offer a substantial return on investment. As with all investments there must be a proper balance between risk and reward.

If the plan is sponsored by a state government or a large and substantial group of institutions, the promise of delivery of future education can be taken with some assurance. The state plans discussed in this newsletter have considerable advantages over independent plans. In addition, higher education is not a uniform commodity. Families want further assurance that the savings will

be usable for the education that **will be desired in the future.** It is, again, clearly advantagous to have a large number of institutions in a plan. Moreover, the colleges in the plan should fall into some natural choice set with a broad range of admissions requirement. An entire state system of higher education may be such a grouping. A set of church related colleges may constitute another natural grouping.

Other forms of flexibility will also improve the utility of the plans for families. Parents will be more inclined to pre-pay for tuition if these payments can be used for any members of the family. Choice of payment schedules will also increase the attractiveness of a plan. New Jersey's draft proposal will allow for payment to stretch over four years. Michigan's plan will provide for a payment period which can extend from enrollment in the plan at birth to enrollment in college (i.e., 18 years).

Withdrawal features are also critical. If the plan allows families to withdraw funds with reasonable appreciation, as is the case with one form of the Michigan program, other restrictions on usage will be more tolerable. If the plan does not allow for withdrawal with appreciation, the parents will want to insure that they can use the investment for college as originally intended or that the prospective gain is so great that it offsets the risk of non-use.

If the plan has less to offer in security and flexibility, it must improve the investment return. Duquesne University's plan is for a single institution — obviously a limited choice. In addition, it has a rather restrictive withdrawal policy (i.e., if the student is admitted to Duquesne, he or she must attend for the freshman year before the investor's funds, with accumulated gains, will be released to another institution). Duquesne balances these restrictions by selling tuition at a substantial discount from current tuition prices.

The investment advantage of a plan can be further improved by tax considerations. If the growth in the value of the tuition prepayment is untaxed, then families have added incentive to save. Flexibility of the plan, however, may also bear on whether there is a taxable gain to the participant. This is discussed below.

In sum, families will save for higher education through these plans if they perceive a favorable balance between risk and return.

Financial Issues for Colleges. College, universities and states that establish savings plans must, like participating families, balance benefits and risks. A major benefit is creation of a secure enrollment base for participating institutions. For states there is the additional political advantage of creating an attractive plan for families which can meet a very real need — saving for the college education of family members. There may also be the potential for economic gain. In fact, a large financial services firm and an individual entrepreneur have been trying independently to develop commercial tuition savings plans because they believe they could offer attractive plans and earn a profit. The risk to plan developers is that the growth in invested tuition prepayments may not be sufficient to match the increase in tuition charges. Analysis of stock and bond returns over the past few decades suggest that this invest-

National Forum Is Established

The National Center on Postsecondary Governance and Finance, recently funded by the Office of Educational Research and Improvement, U.S. Department of Education, has established the National Forum for College Financing Alternatives. The Forum will be a national "clearinghouse" that collects, evaluates, and disseminates new ideas in higher education *capital finance*.

Why capital finance? During the financially-constricted 1970's and 1980's, institutions and state systems have diligently sought new markets, new areas to cut costs, and more funds from traditional sources. These activities will continue. However, institutions are increasingly rethinking their capital position — specifically, they are asking *"Are we undercapitalized?* This question is triggered by growing demands on existing capital resources — to renew and replace plant; to develop new academic programs that are "out in front of the market"; to nuture and invest in new non-academic sources of revenue; to help families fund rapidly rising tuition; to increase faculty salaries, and most importantly, to provide high quality education.

Improved approaches to capital finance and analysis may help meet some of these demands. Institutional solutions will likely include a portfolio of capital initiatives including long-term financing for families, equity participation in corporate-sponsored research, and the judicious use of debt.

The Forum will monitor and evaluate these new financing methods and report them to you. We will also assess the impact of tax and other legislation on these techniques. Coopers and Lybrand will act as technical consultants to the Forum.

ent goal can be achieved — but not by a wide margin.

The investment challenge is obviously greater if the prepayments are at discounted prices. In addition, as the programs become more complex, administrative costs rise, further diminishing the projected investment return. Some of the flexibility features, such as the number of colleges participating or extended payment plans, bear directly on these costs. Recognizing this burden, New Jersey is considering a small service charge on participants who select the extended payment option.

The more restrictive the policies for use and the greater the withdrawal penalties, the less financial risk there is to the plan. Restrictive policies will generate non-users. If these non-users cannot withdraw appreciation of their prepayments, the forfeited gain will add to the total investment return for users. New Jersey is considering an interesting compromise. In their draft plan, the beneficiary must choose one participating college in the state. If the student is not admitted and attends another in-state institution, the investment value of the fund will be transferred dollar for dollar. If the beneficiary chooses an out-of-state institution, only 75 cents on each dollar of the appreciation payments will be transferred to that college.

The more restrictive the policies for use and the greater the withdrawal penalties, the less financial risk there is to the plan.

Another way several plans reduce their total risk is to limit participation. The Michigan plan and the New Jersey proposal both intend to do this. Duquesne limits the use to 400 per year and total use to 2500.

Tax Issues. How these plans will be treated by the Internal Revenue Service is uncertain at this time. There are significant income and gift tax questions. The most important issue seems to be the income tax consequence of withdrawal from the plan. If a participant can withdraw his or her prepayment in cash and with accumulated appreciation, then clearly there is a capital gain and an associated tax. Most plans avoid this by not permitting a **cash withdrawal** of any gain from the program. In addition, there will likely have to be a restriction on the transferability of benefits. The Michigan legislation will offer residents the choice of two plans. In "Plan A" no withdrawal of gain will be permitted. In "Plan B" the participants may withdraw both the nominal investment **and** appreciation. It is possible that there may be a tax liability. A revenue ruling is being sought. Regardless of the results of that ruling, this alternative will be quite suitable for the investment of trust funds or funds in the name of a minor. In such cases the taxes are likely to be low or non-existent. Whether pre-purchased tuition can be converted to tuition or other educational costs at non-participating institutions without tax consequences is unclear at present. Revenue rulings will be sought. If these rulings are unfavorable, challenges are likely.

This uncertain tax environment need not stop the development of tuition savings plans. However, all programs should be created carefully and with tax counsel closely involved.

Forum Launches Newsletter

This is the first issue of the Forum's *Captial Ideas*. *Capital Ideas* will be published quarterly. Each issue will generally cover one capital financing theme; this issue addresses tuition savings plans — future issues will cover equipment financing, real estate financing, institutional, student and family loans, etc. The Forum will also communicate research findings through seminars, monographs and micro-computer models.

Key Features of T

TWO INSTITUTIONAL SAVINGS PLANS

	Calvin College	Duquesne University
Plan Overview:	Guarantees tuition in any year at Calvin. Sold in units equal to 1/100th of current tution.	Guarantees tuition for 120 credits at Duquesne, issued in the name of an individual.
Purchase Amounts:	Any amount of 1/100th tuition units.	Lump sum only, bank financing is available.
Eligibility:	Anyone.	Duquence alumni dependents, nephews, nieces and grandchildren. Others may be enrolled at slightly higher prices.
Price:	Current price at Calvin College.	Discounted from current Duquesne tuition, rates based on age of the enrollee.
Corporate Structure:	Within Calvin College Corporate structure. Funds are separately invested.	Within the Duquesne University corporate structure. Funds are separately invested.
Withdrawal Features:	None. May be turned over to the College as a gift with standard tax advantages.	If students is not accepted, the original investment is refunded. If accepted, the student must take the first 30 credits at Duquesne; afterward, Duquesne will pay 90 credits to another institution at the lower of Duquesne's or the transfer college's tuition. Student must maintain a 2.5 average to transfer and maintain that average *after* transfer.
Investment Risk:	If return on invested funds is less than the future increase in tuition, College will have reduced revenues.	If return on invested funds is less than the future increase in tuition, University will have reduced revenues.
Transferability:	Fully transferable.	Nontransferable.
Other Features:	—	Participation limited to 400 per year of use and 2500 total.
Status:	Operational. Approximately 300 participants as of April 1, 1986.	Operational. 482 participants as of April 1985. 49 inquiries recorded as of March 26, 1986.

tion Savings Plans

TWO STATE SAVINGS PLANS

	Michigan	New Jersey
Plan Overview:	Guarantees tuition for 120 credits at any public four-year college or university. Issued for a specific "year of first use." Two plans from which participants may choose. *Plan A*: Participants may withdraw only their original investment; this plan should offer tax shelter to those who use it. *Plan B*: Participants may withdraw principal and appreciation. Appreciation will be determined by investment value of payments or increase in tuition costs at Michigan colleges, whichever is less. Although there may be a tax on the gain, this plan may be most appropriate for trusts or funds held in the name of a minor. (A revenue ruling is being sought.)	(Discussion draft only) Guarantees tuition at any participating institution, *public or private* within the state. Participants select only **one** institution.
Purchase Amounts:	Lump sum or smaller regular payments. Payments may be stretched for as long as 18 years.	At least one year. Up to four years. Payments may extend over 48 months.
Eligibility:	Michigan residents only.	Contributor must be a state resident *when initiating the plan*.
Price:	Discount from current tuition rates based on "year of first use."	Current price of the selected institution.
Corporate Structure:	Public agency within the Department of Treasury. Governed by an independent board. Funds are separately invested.	State agency.
Withdrawal Features:	Participants may withdraw funds only under certain conditions. These include death, disability, non-admission, or attendance at another college or university. *Plan A* - Participants withdraw only original investment. *Plan B* - Participants withdraw investment plus accumulated gain.	If beneficiary does not attend college, original investment without gain can be withdrawn. If beneficiary is not accepted at selected institution, tuition pre-purchase value may be applied to another participating institution dollar for dollar. If tuition is higher, beneficiary/contributor must make up the difference; if tuition is lower, excess may be applied to other educational costs. If student attends out of state institution, 75% of the tuition pre-purchase value will be applied.
Investment Risk:	If growth of funds does not match rise in tuition, the fund is at risk. The state has back-up risk.	Institutions incur primary risk. They receive the lower of their resident tuition or the investment value of the pre-purchased tuition. However, the state is also at risk — it guarantees to supplement the investment value if it falls below 75% of current resident tuition.
Transferability:	Not determined at this time.	None.
Other Features:	Number of participants is limited so that the discount in current price can be adjusted based on experience.	Number of participants can be limited by colleges.
Status:	Legislative hearings are in process.	Chancellor of higher education has initiated a discussion of this and other proposals.

Forum's Model Plan

The plan outlined below incorporates many of the most attractive features of tuition savings programs we reviewed. Whether or not it is the "best" plan for you will be determined by your unique financial and operating environment.

Plan Overview:

The guarantor organization — a public authority or non-profit corporation — sells "standard tuitions units" (STU's). The STU's may be determined in any number of ways. If a state runs the program, the STU could be the annual average cost per undergraduate credit at a public four-year institution. Tuitions for all participating colleges would be indexed against the STU price. The purchaser buys as many STU's per year as desired. The price changes every year. Participating colleges charge tuition in dollars and STU's. For example, an individual attending a typical state four-year institution would expect to use 30 STU's for one year of full-time study. At a community college he/she might only "spend" 15 STU's for a year of full-time study. Tuition at a private college would require considerably more STU's.

Advantage: Flexible. Allows many types of institutions to participate (including graduate schools.)

Disadvantage: Complex. May be difficult to explain to families and to market.

Purchase Amounts;

Any number of units in any year.

Eligibility:

To be set by program.

Price:

Current price based on "standard set" of institutions. Discounts could be offered.

Corporate Structure:

Public authority or non-profit corporation.

Withdrawal Features:

Two plans similar to Michigan. One allows for the withdrawal of gain and has tax consequences. The other would permit only the withdrawal of the nominal investment with no tax consequences likely.

Investment Risk:

Choice of (1) the public authority or non-profit corporation, or (2) the colleges.

Transferability:

Within the family.

Update: Federal Legislation

National Savings Plan Unlikely

On January 28, 1986, Senator Charles McC. Mathias, Jr. of Maryland re-introduced his proposal for *education savings accounts* (S.2024) to the 99th Congress. The education savings account plan would "provide incentives for saving, defer taxes on principal and earnings for the investor, benefit many people in addition to those who cannot afford to save, make new scholarship funds available through tax-exempt contributions, and thereby provide additional funds to students who are otherwise unable to finance their education." According to Richard Weston, a spokesperson for Mathias, the bill is "resting" and will probably not pass this session. "Congress will not be the leader in innovative financing of higher education, leadership will have to come from the higher education community," said Weston.

Tax Reform's Impact On Plans

In early May, much to the surprise of the tax community, the Senate Finance Committee approved a sweeping tax reform package. Suddenly a tax overhaul is no longer perceived as a distant threat — or promise — but a near certainty. **Capital Ideas** will report on tax reform as it occurs. This issue will briefly consider the potential impact on college savings plans.

The various changes contained in the House and Senate proposals have a mixed effect on the attractiveness of college savings proposals. The cut in the top tax rate to 38 percent (House) or 27 percent (Senate) reduces the incentive to shelter income. However, in high tax states (e.g. Calif., Mass., N.Y.) the total top marginal bracket will still exceed 50 percent. In addition, the loss of other tax shelters will make any tax advantages of the savings plans more attractive. Another significant provision for the savings plans is the proposal to restrict income shifting to children. Both the House and Senate versions propose to tax children's income, above the standard deduction, at the parents' rate. Such a change would reduce the attractiveness of trusts or transfers to children under the Uniform Gift to Minors Act. As a result the pre-purchase of tuition becomes a viable alternative to these more standard forms of college savings. For a modest amount of college savings, say four years of public college tuition, the proposed increases in the standard deduction will be large enough that the standard trusts and transfers will provide total shelter for the derived income.

Perhaps most important is the threat of the loss of the tax deduction of interest expenses. Using debt for college financing is considerably less burdensome when the interest costs are deductible. Under the Senate proposal interest deductions would be limited to interest income except for interest on mortgages. If the senate proposal on interest deductions holds, we can expect more colleges to be offering savings plans . . . or second mortgages.

Opening Up Communications

Do you have ideas on Capital Finance? If so, we want to hear from you.

Would you like to receive this newsletter in the future, as well as other publications of the National Forum for College Financing Alternatives? If so, please write or return the form below.

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a newsletter of the **NATIONAL FORUM FOR COLLEGE FINANCING ALTERNATIVES**

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